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Marginal Rate Reductions
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President Bush has proposed a tax reduction package that has, as its centerpiece, a reduction in marginal income tax rates. Other features of his tax and budget plans address peculiar features of the tax code that result in high implicit marginal tax rates on the poor, the elderly, and some two earner married couples. The President's focus on marginal tax rate reduction is key to restoring incentives to work, save, and invest, to maintaining and strengthening the economic expansion, and to renewing job growth and real income gains. His proposals should be implemented as soon as possible.

The main elements of the tax proposal.

Marginal tax rate reduction. The President's tax plan would trim marginal income tax rates over 5 years. The 39.6% and 36% rates would fall gradually to 33%. The 31% and 28% rates would drop to 25%. The bottom portion of the 15% rate would drop to 10%.

Based on the 1997 income distribution (last available year), the Bush proposals would reduce the income-weighted average marginal rate from 25.4% to 22.9%, about a ten percent drop. (See Chart 1.) By comparison, the Kennedy and Reagan marginal tax rate reductions were between 20 and 25 percent. Chart 2 shows the reduction in marginal income tax rates under the Bush plan for couples at various income levels, assuming they have two children and are not subject to the alternative minimum tax.

At the margin, on an income-weighted basis, and accounting for payroll and state income taxes, the President's proposed rate cuts would raise the after-tax wage on incremental effort by about 4 percent, and the after-tax return on incremental saving and non-corporate investment by about 3 percent. We estimate that these additional rewards to production would create between 1.5 million and 2 million additional full-time equivalent jobs over the next decade, and ultimately add close to 2% to the GDP. Individuals would not only benefit from the lower tax liabilities, they would experience higher pre-tax wages and increased employment opportunities as well. The taxes collected on the increased personal and business income from the higher GDP would eventually return between a quarter and a third of the static revenue cost of the tax cut to the government.

These employment and GDP calculations do not include the additional beneficial impacts of the President's proposals relating to the marriage penalty and the earned income tax credit (EITC), nor do they allow for the adverse effects of the alternative minimum tax.

Rate relief for two-worker couples subject to the marriage penalty. The President's proposed "second worker exclusion" is designed to provide relief to two earner couples in rough proportion to the degree of marriage penalty they are experiencing under current law. The couple could deduct 10% of the lower earner's first $30,000 of wages (a deduction of up to $3,000) from taxable income. The deduction would trim the tax liability of such couples. In addition, where the lower earning spouse has less than $30,000 in labor income, this would represent a further 10% cut in the marginal tax rate on incremental earnings, and thereby encourage further effort. (For example, it would effectively reduce the 15% tax rate to 13.5%, and the proposed 25% tax rate to 22.5%.)

Rate relief for workers hit by the EITC phase-out. The refundable earned income tax credit (EITC) eliminates the income tax and much of the payroll tax for several million low income workers. As incomes rise, however, the credit is phased out. The phase-out for a couple or single parent with one child is at a 15.98% rate between incomes of $13,090 and $28,280; for parents of two children, at a 21.06% rate between incomes of $13,090 and $32,120; for couples with no children at a 7.65% rate between incomes of $4,760 and $5,950.

When income is in the phase-out range, each additional dollar of income costs the taxpayer $0.1598, $0.2106, or $0.0765 of the credit. In addition, the taxpayer is subject to the employee's half of the payroll tax at a rate of 7.65%; to the first 15% income tax bracket rate; and, in most states, a state income tax. Assuming a state tax rate of 5%, the combined marginal tax rate on an added dollar of income in the phase-out range for a worker with two children is 48.71%. The government is taking nearly half of any additional income that this low-earning taxpayer struggles to make. Such high marginal tax rates are a serious disincentive to work and earn one's way out of a near poverty situation.

The President's proposal would reduce the work disincentives on low income workers created by the phase-out of the EITC in two ways. First, the plan would cut the 15% tax rate to 10% for the first $6,000 of taxable income for a single filer, $10,000 for a single parent, and $12,000 for a couple filing jointly. Second, it would increase the child credit from $500 to $1,000. These steps would eliminate the income tax for many recipients of the EITC, thereby reducing by 15 percentage points the marginal tax rate that they face on income in the phase-out range. Their EITC would be fully phased out before they begin to pay income tax, and they would not be subject to the explicit income tax rate and the implicit phase-out tax rate on the same income. Chart 2 shows the reduction in the marginal tax rate spike due to the EITC for a couple with two children.

This approach does have a drawback. It exempts several million additional people from the income tax. It is not a good idea to have a large part of the voting public thinking that on-budget government services are free goods.

Elimination of the estate and gift tax. The President's proposal would also phase out the estate and gift tax. This tax is a serious impediment to small business survival in particular, and to saving and investing in general. It even discourages work by seniors who are thinking of deferring retirement to add to their bequests. The estate and gift tax rates can reach 55% at the margin (60% in the surtax region as the lower rates are "recaptured") for an ordinary estate, and nearly 80% for a generation skipping trust. Combined with payroll and income taxes, it can result in marginal tax rates on additions to bequests of between 70% and 91%, clear disincentives for the elderly to work and save. (See Chart 3.) Elimination of the tax would be good for the economy. It would save as much in wasteful legal costs as it raises in revenue. It would probably pay for itself in two ways. First, when high tax bracket parents give money away during their lives to their low tax bracket children to avoid the estate tax, the taxes on the current earnings of the assets are reduced, costing the government current revenue; ending the estate tax would reduce such losses. Second, ending the estate tax would increase total saving, investment, output, and taxable income, yielding a dynamic revenue gain.

In removing the estate and gift tax, some people would propose ending step-up in basis for capital gains at death. I would advocate retaining step-up in basis. It is consistent with the saving/consumption neutral treatment of capital gains found in major tax reform proposals. If saving has received pension or IRA treatment, the gain will be taxed under current law as ordinary income to the heir (although such tax would better be deferred until the assets are sold for consumption). If the saving did not receive pension or IRA treatment, the gain should remain untaxed, as in a Roth IRA. If step-up is eliminated, the heir should not have to pay capital gains tax at the time of inheritance, but only later when the assets are sold and the gain is realized.

Making the R&D credit permanent. The plan would make the research and development credit permanent, giving businesses a more certain foundation on which to plan their investment in basic science, technology and new products.

Above the line charitable contributions. The President would allow taxpayers who do not itemize to deduct their charitable donations. This is good tax policy as well as social policy. Income transferred to others is no longer the property of the donor and should not be taxed as such. It should be treated as income to the recipient (who, in the case of a charitable donation, would be an individual too poor to owe tax, or be a tax exempt institution).

Social Security earnings test repeal. President Bush has previously proposed eliminating the remaining portions of the Social Security earnings test. While not technically a tax proposal (it raises Social Security outlays), the earnings test acts as a 50% add-on tax rate on incremental wage income above a low exempt amount for beneficiaries ages 62 to the normal retirement age. The test has been eliminated for retirees above the normal retirement age. The normal retirement age was 65, but is rising in stages to 66 for people turning 62 between 2000 and 2005, and to 67 for people turning 62 between 2017 and 2022. Thus, people ages 65 and 66 will again become subject to the test. Removing the remaining earnings test would sharply reduce an outrageously high tax rate on older workers, and restore work incentives to some of our most experienced and productive citizens. If this cannot be done in the first tax bill, it should be considered for the next available vehicle.

A picture of the marginal incentive effects of the tax proposals.

Chart 2 shows marginal tax rates for married couples with two children at various income levels under current law and the Bush plan. The marginal rate reductions across a wide range of incomes provide the incentives to boost production and output that are the major economic benefits of the proposal.

Note that the phase-outs of the child credit, itemized deductions, and personal exemptions push effective tax rates above the statutory levels. For a family of four, under current tax rates, the exemption and deduction phase-outs add nearly 4 percentage points to the tax rate (a bit more or less depending on the specific tax bracket). Eliminating these phase-outs would provide significant additional marginal rate relief, and would bring the top rates down to a true 25 or 33 percent.

There are many other provisions in the tax code that implicitly boost marginal tax rates, such as the tax treatment of Social Security benefits, income related limitations on IRAs, and the loss of various credits. A complete list with details is available in IRET Economic Policy Bulletin No. 83, "Phaseouts Increase Tax Rates and Tax Complexity", (forthcoming in March in hard copy and on the web at www.iret.org).

AMT relief.

The regular income tax relief proposed by President Bush could subject several million additional taxpayers to the AMT unless the AMT is reformed or repealed. It would be wise to alter the AMT to allow taxpayers to receive the full benefit of the President's proposed rate reductions, and the full value of the child credit and the EITC.

Chart 2 assumes that the families are not thrown into the alternative minimum tax. If they fall under that tax, the marginal tax rates for the upper income families would be slightly higher or lower at various points. (See Chart 4.) The statutory AMT marginal tax rates, 26% and 28%, are lower than under the ordinary income tax, but imposed on a broader base to collect more revenue than the ordinary tax. However, the 25% phase-out rate of the AMT exempt amount has the effect of boosting the marginal tax rates in the phase-out range to 32.5% and 35%. (See Chart 5.) Thus, at the margin, the AMT rates would not be much less than the ordinary income tax rates in the Bush plan for many affected taxpayers.

Even under current law, the AMT is poised to strike millions of additional taxpayers with middle-class incomes. The number of individual taxpayers owing the AMT jumped by 38% in 1998 alone (from about 620,000 to about 850,000). The IRS Taxpayer Advocate projects that unless the law is changed, "Over 17 million taxpayers will be subject to the Alternative Minimum Tax by the year 2010. [And by that year] taxpayers with an adjusted gross income of less than $100,000 will owe "60% of the nation's Alternative Minimum Tax..." The AMT is in need of urgent attention.

Why cut marginal tax rates?

The type of tax reduction is important. Tax cuts do not boost the economy by giving people more money to spend (to pump up "demand"). The same amount of money would be given back to federal bondholders if taxes were not cut. Private sector spending power and demand do not change just because federal revenues are reduced. That is why President Ford's $35 rebates in 1975 were such a failure; the money was just borrowed back to cover the added federal deficit. Such hand-outs simply use up money that could be used for more beneficial tax changes. Thus, a tax cut should not be thought of, or worse, designed as a counter-cyclical Keynesian "stimulus" to demand.

Tax cuts work to improve the economy if and only if they increase, at the margin, the after-tax wage on additional hours worked, or raise the interest and dividend returns on added saving, or raise the rate of profit on capital investment. These tax cuts first promote an increase in the supply and employment of labor and capital resources, which are used to create added goods and services. The suppliers of the resources are paid the value of their added output for their trouble, and they can then use their added income to buy the added output they have produced. The output, factor payments, and sales all stem from the production process. Demand rises together with supply or not at all. If the tax cuts are not "at the margin", they do not increase demand, or production, or income.

Marginal tax rate cuts are not inflationary; they are disinflationary because they lower the cost of labor and the cost of capital. Tax rate reductions expand capacity; they raise output and income simultaneously, increasing supply in line with demand. Put another way, they encourage creation of additional goods and services, and with costs down and more goods "chasing" the same amount of money supply, the price level is reduced. Because such tax cuts are disinflationary, there is no reason for the Federal Reserve to oppose them by tightening money.

Tax changes "at the margin" may either be reductions in the statutory marginal rates or changes to the tax base on which the rates are imposed, so long as the result is a reduction in the tax on incremental income. Thus, fixing the tax base to end multiple taxation of income used for saving and investment is also a tax cut at the margin, and is the key to fundamental tax reform. The best tax cuts would move the code in the direction of fundamental tax reform.

Marginal tax rates are rising and threatening the expansion; they should be cut.

As Chart 1 shows, marginal tax rates have been rising in recent years due to enacted tax rate increases in 1990 and 1993, to "real income bracket creep", and to changes in the work force and job mix. These marginal tax rate increases have been reducing the incentives to work, save and invest. Put another way, the tax rate hikes have been increasing the cost of labor and reducing the profitability of investment, resulting in slower growth of labor and capital inputs, output and income than would otherwise have occurred. Left untreated, rising marginal tax rates would gradually slow the economic expansion.

Chart 1 traces the history of income-weighted average marginal income tax rates. (The rates are weighted by taxpayer income as a proxy for hourly earnings of taxpayers in each tax bracket. It does not include payroll taxes, nor calculate the effect of the growing impact of the alternative minimum tax.)

Marginal income tax rates soared in the inflationary 1970s through 1980 as rising nominal incomes forced taxpayers deeper into the progressive tax rate structure. The result was falling real after-tax incomes, rising labor costs, strikes, unwillingness to accept overtime, and a rapid increase in non-taxable fringe benefits. Other adverse tax effects of inflation crippled business investment.

The 1981 tax rate reductions (the Economic Recovery Tax Act of 1981, ERTA) lowered marginal tax rates over the next four calendar years. ERTA then stabilized the rate cuts by means of tax indexing, which enlarges the personal exemptions, the standard deduction, and the dollar levels at which each tax rate bracket begins in line with inflation. Indexing prevents a cost of living allowance from forcing taxpayers into higher tax brackets (bracket creep). With indexing, taxpayers do not experience a tax rate hike unless their incomes rise in real terms, that is, faster than inflation. However, indexing does not prevent real wage gains or rising real family incomes from increasing tax rates.

The Tax Reform Act of 1986 further reduced individual marginal income tax rates in 1987 and 1988. There was a minor increase in marginal tax rates in the 1990 tax bill, offset by the dip in income in the 1990-91 recession and the subsequent sluggish recovery of output and real income. The 1993 tax increase raised marginal tax rates on upper income earners.

Resumption of stronger real income growth since about mid-1995 has kept marginal tax rates rising ever since. Some of this increase in marginal tax rates is due to real bracket creep as workers in various occupations have experienced real wage growth. Some is due to rising family incomes as more families become two worker households. Some is due to increased numbers of high tech, high value added, high paying jobs.

Insurance against recession.

The current economic slowdown is an additional reason for moving ahead promptly with the President's tax plan. Whatever plan is adopted should still be the right type of tax cut, one that promotes growth by increasing production incentives <u>at the margin</u> for workers, savers and investors and removing biases in the current tax system against investment and saving. Otherwise the tax cut will have no effect either short term or long term.

Recession offset? The President originally proposed that his rate cuts be phased in between January 1, 2002 and January 1, 2006. Due to the weak economy, however, it has been suggested that it would be better to advance the cuts by a year, with the first installment effective January 1, 2001. Opponents protest that the economic slowdown may be over before the tax cuts are passed, and that they may "overheat' the economy.

Incentive-based tax rate cuts are beneficial whether they are enacted at the bottom of a downturn, in the middle of a recovery, or at the top of a boom. By expanding productive capacity in line with spending, they improve the economy in all cases. They should be viewed as a policy for the long term, not as counter-cyclical fine tuning. Nonetheless, if marginal rate cuts happen to be enacted at a time of economic weakness, they can help to restore growth by encouraging employment and investment. They would lift economic output at any time; that this effect would be especially welcome in a period of weakness is merely an added benefit.

Again, tax cuts do not work simply by giving people money to spend (to pump up "demand"), and they are not inflationary. In times of deficit, a tax cut is borrowed back by the government to maintain spending; in times of surplus, a tax cut reduces repayments to the bondholders. In neither case is there any increase in the amount of money in circulation "chasing" too few goods and driving up prices. Only the Federal Reserve can create inflation by over-expanding the money supply relative to the availability of goods and services.

Retroactive? If the marginal tax rate cuts are to have any significant effect on the economy in 2001, they need to be enacted promptly, have as deep a marginal rate cut as possible up front, and not be put in question by "triggers".

The tax cuts do not need to be made retroactive to give people money to spend (because they would not do so). However, tax rate cuts must be effective as of the start of the year if they are to achieve the full incentive effect on production behavior implicit in the percentage rate reduction. Delaying a tax rate reduction until mid-year, for example, would cut the incentive effect of that year's rate cut in half. If one of the objectives of the tax rate reductions is to head off current economic problems, the first installment of the multi-year rate cuts should date back to January 1, 2001. Even better would be to front-load the rate cuts rather than string them out over five years.

Individual income taxes are collected on a calendar year basis. The IRS does not distinguish between income earned in January and income earned in December. Tax rate cuts occurring mid-year are pro-rated by means of a "blended rate", and do not have their full marginal incentive effect their first year. For example, a hypothetical 10% across the board rate cut effective July 1, 2001, will effectively cut the marginal tax rate on all income earned in 2001 by 5%, because all calendar year income is lumped together for tax purposes. The full effect of the marginal rate cut will not be felt until 2002, when it is in place for the full calendar/tax year. The earlier in the year a rate cut is made effective (including retroactive to January 1), the more nearly the tax rate reduction will have its full incentive effect.

Rate cuts work well, when implemented promptly.

The Kennedy tax cuts of the 1960s were implemented quickly to fight the back to back recessions of 1957 and 1961. Kennedy created the investment tax credit (ITC) and reformed depreciation rules in 1962, and cut the corporate tax rate in two steps, from 52% in 1963 to 48% in 1965. His famous individual income tax reductions (passed under President Johnson) were a roughly 25% across the board cut in marginal rates, phased in over two years, 1964 and 1965. The economy was strong and inflation was modest in the mid 1960s. Subsequent monetary excesses and tax increases hurt the economy 1969 and the 1970s.

In 1980, President Reagan proposed a 30 percent across the board tax rate cut, to be phased in at 10 percent a year, each January 1, for three years. Due to budget concerns, he was persuaded to delay and scale back the tax cut. As passed in the Economic Recovery Tax Act of 1981 (ERTA), the total tax rate cut was trimmed to 25% across the board. The first installment was cut to 5 percent and delayed until October 1, 1981. The second and third installments of 10 percent each were moved from January 1 to July 1 for 1982 and 1983.

The result was a blended marginal rate cut of 1.25 on 1981 income, a 10% cut for 1982 income, 20% for 1983 income, and a full reduction of 25% only for 1984 income. The pitiful 1.25% rate cut for calendar year 1981 was more than offset by a scheduled payroll tax rate increase and by inflation-induced rate hikes due to bracket creep. Tax rates actually rose in 1981. Another round of payroll tax hikes and bracket creep in 1982 offset that year's tax rate cut as well. There was no significant net marginal tax rate relief until 1983.

These cutbacks and delays were ill-advised. They made it impossible for the tax reductions to avert or moderate the impending 1981-1982 recession. The Federal Reserve had begun tightening monetary policy in November 1980, the day after the election, to battle the double digit inflation then rampant, and because the Fed erroneously expected the promised tax cuts to pump up demand and add to inflationary pressures. The economy softened rapidly, contrary to Federal Reserve expectations, and was already entering a recession in the summer of 1981 even as the tax bill was finally coming up for a vote in Congress. The economy did not rebound until 1983, the first year of real net tax rate relief. The rate of inflation collapsed much faster than was anticipated by the Federal Reserve and the Congress. The disinflation and eventual resumption of strong real growth and job creation (which the tax cut did eventually generate) could have been accomplished more quickly and with less pain if key policy officials had better understood the disinflationary nature of the tax cuts and allowed them to take effect sooner.

No triggers, please.

Some Members of Congress want to impose a "trigger" on President Bush's proposed across the board cuts in marginal tax rates. Under a trigger, the various installments of the rate cuts would only go into effect if projected budget surpluses arise as forecast. A trigger would make the tax rate cuts less effective in strengthening the economy and could lead to the bad budget outcome its advocates claim to fear.

An invitation to over-spend. Tying tax cuts to the budget surplus would let Congress block the tax cut just by spending too much. There would not even be an explicit vote to hold the Members accountable. If the surplus is the issue, rather than the urge to splurge, why not propose a trigger on federal spending instead of tax cuts?

A trigger makes a tax cut cost more. Making the tax cut uncertain would reduce its effectiveness at promoting growth. If people can count on the tax cuts, they will produce more in anticipation. If people doubt the cuts will occur, growth will be delayed. The revenue reflows would be less, and the deficit higher than otherwise.

Every year we <u>don't</u> have a tax cut, productivity gains and real wage hikes actually raise tax rates on workers and cost some jobs that would otherwise occur (because tax indexing only offsets the inflationary component of tax bracket creep, not the kind due to real wage growth). If, instead, employers know that the tax burden on workers will be dropping over time, and after-tax wages will be rising, they will expect wage demands to remain moderate. They will be more likely to hire people, today, on that assurance, than if taxes are not going to be cut.

But what are employers to think if a tax bill says "We might lower taxes for the next five years, or maybe not?" They'll hold off on the hiring until they see the green of the tax cuts. Similarly, savers and small business owners will wonder what tax rates they will pay on future interest and business income, and will cut their saving and investment accordingly.

The tax cut is not too big, it is too small.

The President's tax proposals are not too big. Indeed, to have a significant effect on the 2001 economy, the rate reductions would have to be phased in faster. As presented, they are barely over 1% of GDP over the 10 year budget window. Relative to GDP, that is about half the size of the Kennedy tax cut and about 40% the size of the individual tax reductions in the 1981 Reagan tax cut. The Bush rate cuts would be phased in over five tax years. The Kennedy rate cuts were implemented over two tax years, and the Reagan cuts over four.

Some tax cut opponents fear that the size of the Bush tax plan is understated. They would raise the estimated cost of the Bush plan from the original $1.6 trillion by $500 billion if the tax cut is made retroactive to January 1, 2001, expiring AMT offsets are renewed, and the full tax cut is given to people who would otherwise be thrown into the AMT by lowering ordinary tax rates. They would raise the estimate by another $400 billion to $500 billion for interest if the debt is drawn down more slowly. The total, they claim, could reach $2.6 trillion over ten years, and leave little money "on-budget" to retire the federal debt.

There are several reasons not to be concerned. First, the CBO budget projections are for just over $3 trillion in on-budget surpluses over ten years. Even with the augmented tax cut, and counting the added debt service, there would still be an on-budget surplus.

Second, "off-budget" Social Security surpluses will total nearly $2.6 trillion. Even with the tax cut, publicly held debt and interest payments to the public would be gone in ten years in the absence of further tax reductions or spending increases.

Third, the estimated cost of the tax rate cut is "static", not counting the added economic growth the rate cuts would make possible. The stronger economy would return about 30 percent of the projected revenue loss to the Treasury. That puts the cost of the rate cuts far below the projected on-budget surplus, even adjusting for added interest expense.

Fourth, CBO estimates of the surplus may be on the low side. The graduated income tax takes in a rising share of income as the country becomes more prosperous, and more taxpayers run afoul of the unindexed AMT each year. Increased factor productivity should also boost corporate income and corporate taxes as a share of income over time. Yet CBO projects tax revenues per dollar of GDP to fall over the next decade in a pattern at odds with historical experience. CBO assumes, among other things, a drop in capital gains revenues to more "historical" levels over time. Capital gains receipts may in fact fall sharply from last years elevated peaks due to the recent market dip. Nonetheless, the stock market remains substantially higher than 10 or 20 years ago relative to GDP, and gains should be higher, on average, as a share of current income for a long time to come.

Fifth, the CBO and Administration budget forecasts contain conservative real GDP growth assumptions, 3 percent per year for CBO and 2.7 percent per year for the Administration. The private sector consensus is nearer 3.3 percent. There is substantial room for revenue surprises on the upside in the CBO and Administration budget forecasts.

Surplus estimates will be rising for several years to come. Moving the budget window out one year would drop FY2002, with a surplus of just under $300 billion, and add FY2012, with a surplus of nearly $900 billion. That would boost the surplus projection by nearly $600 billion. Similar increases would occur in each of the next several years. There will be ample money available for additional tax relief in a later bill.

No rush to pay off the debt.

President Bush has proposed paying off about $2 trillion in debt, with the remainder of the surplus used for tax relief and the associated debt service, plus a "contingency" fund and Medicare reform. This would leave a bit over $800 billion in federal debt in the hands of the public (including state, local, and foreign governments) in 2011.

Some would ask, "Why not pay off the entire debt?" The President replies in his budget papers that paying off debt that has not matured would involve substantial premium payments to the bondholders, making repayment a bad deal. Also, requiring people to redeem U.S. savings bonds would destroy an excellent savings program. Furthermore, holding U.S. securities is a great convenience to risk-averse savers and to other governments. An additional point is that the Federal Reserve normally controls the money supply by buying and selling federal securities. It would have to use other assets or other techniques if the marketable U.S. government debt disappears.

Perhaps a better question is, "Why pay off the debt anyway?" There are surely better things to do with the money. (I would nominate fundamental tax reform, providing personal saving accounts to cushion the necessary adjustments to Social Security when the baby boom retires, and medical research to utilize the fruits of the human genome project to cure disease.). Federal debt is risk-free. It is accorded some of the lowest real interest rates on the planet. Using the surplus to promote the growth of the economy would yield the country and the government a higher rate of return than drawing down the debt at a faster clip.

Tax cut foes contend that lowering the debt faster is the best way to increase saving and investment. They are wrong. Paying down more debt instead of lowering taxes would have virtually no impact on global interest rates. The additional debt reduction would be a drop in the bucket compared to the amount of financial assets outstanding in the world credit markets (some $80 trillion to $100 trillion). Such small differences in the repayment schedule would have no effect on world interest rates, but the higher taxes would come straight out of private saving and investment.

Therefore, faster debt reduction would not boost investment and employment. By contrast, cutting taxes on capital, at the margin, would increase saving and investment. Examples include marginal tax rate reduction, enhanced IRA or pension treatment of saving, and faster recognition of the cost of investment for tax purposes (accelerated depreciation write-offs). Cutting taxes on labor, at the margin, is also pro-growth because people work more for higher after-tax wages. Not all tax cuts spur enterprise, but the various rate reduction features of the President's tax plan are definitely pro-growth.

In effect, the country is in the position of a family with a $50,000 mortgage, $40,000 in annual income, and $35,000 in annual expenses (including the mortgage payments). Should the family put its $5,000 surplus in the bank or the stock market, or use it to pay down the mortgage faster? That depends on how high the interest rate is on the mortgage, what returns the family could get from the bank or the stock market, and what it might need the money for in a few years. If the mortgage rate is 6% and the interest, dividends and capital gains returns on bonds and stocks are 8%, the family would be better off saving the money. If Junior is just starting high school, and the family needs to add an additional $20,000 in savings over the next four years to complete Junior's college fund, it would be better off keeping the money. If it paid down the mortgage instead, it would only have to borrow the money back four years hence to make the tuition payments. Debt reduction makes sense only if it is the most valuable use of the money.

Tax issues for a later bill that would move toward fundamental tax reform.

Other features of the tax code have resulted in high, sometimes outrageous marginal tax rates, with a substantial tax bias against saving and investment. These biases and abnormal tax rates could all be corrected by moving to a fundamental tax reform that establishes a saving/consumption neutral system. Short of fundamental reform, there are many steps that can be taken to reduce the distortions and biases.

Shorten all asset lives in the capital cost recovery system. This step would reduce the cost of capital at the margin on new investment. It would give the most bang for the buck for long term growth and have a quick effect on the economy. It addresses the slump in investment that is part of the current softness. The ultimate goal should be expensing, as in a saving/consumption neutral tax system.

Enhance IRAs and 401(k)s as in last year's Portman-Cardin bill. Expanding pension treatment of saving is a step towards fundamental tax reform, in which all saving would receive that treatment. It would be useful to combine all retirement and education saving incentives into one large, simple program. Penalties, withdrawal restrictions, and contribution and income limits should be eased or ended.

Reform the tax treatment of Social Security benefits. The formulas for taxing Social Security benefits impose very high marginal tax rates on wages and savings income by boosting the 28% tax rate to an effective 42% or 52% as up to half or 85% of benefits become subject to tax. Combined with the earnings test and the payroll tax, marginal rates on wage income can exceed 100%. Taxation of benefits needs to be completely redesigned and decoupled from other income to avoid this tax spike.

Eliminate the phase-outs of personal exemptions and itemized deductions (and other phase-outs where feasible). Ending these phase-outs is equivalent to an additional marginal rate cut of 1 to 4 percentage points, and would simplify tax filing.

Get rid of the personal and the corporate AMT. The AMT distorts the definition of income and accelerates tax payments in an inappropriate manner. In the process, it makes investment less profitable and reduces the capital stock, productivity, and wages.

Reform Social Security by diverting 2 or more percentage points of the payroll tax to personal accounts.

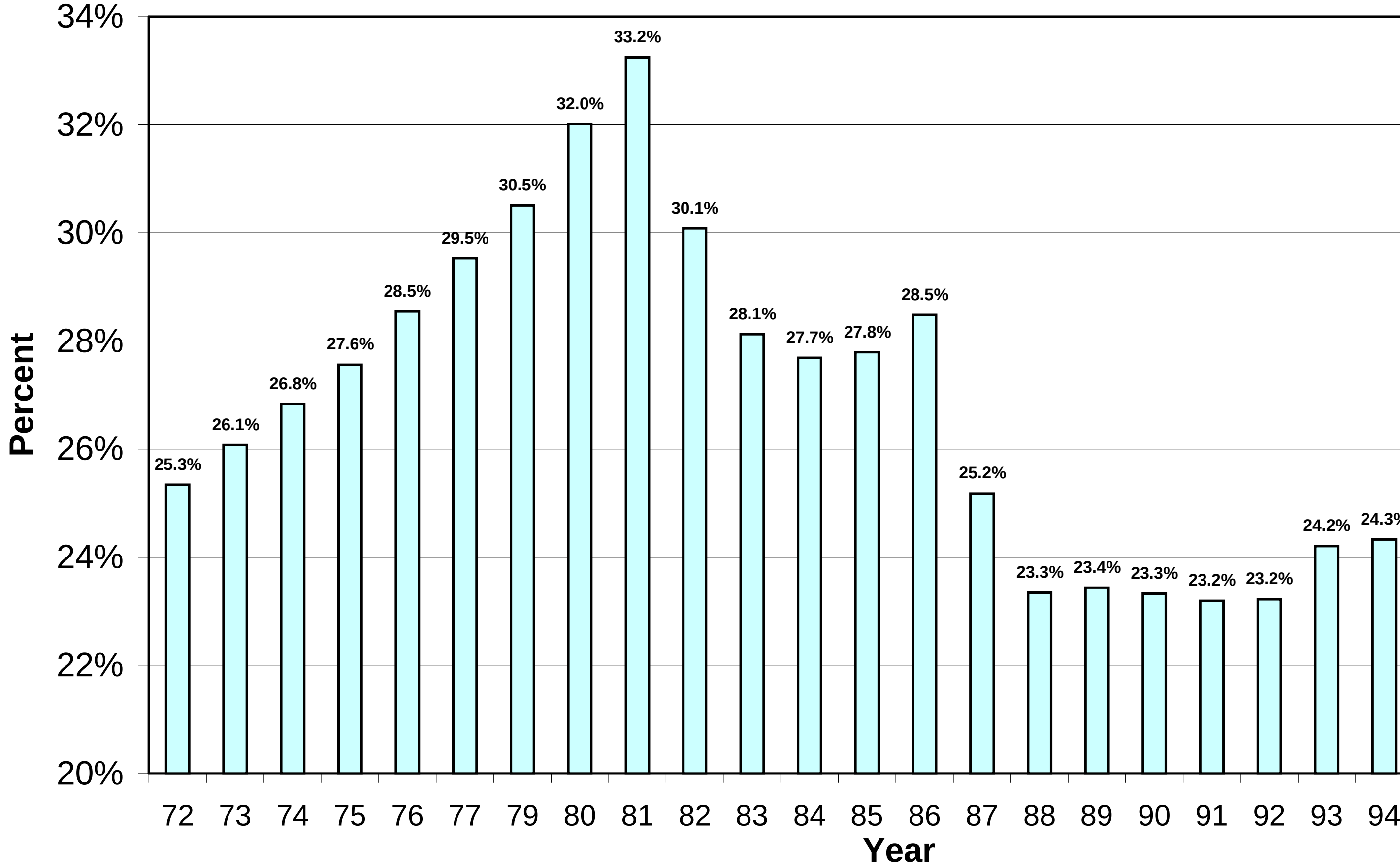
Conclusion

Letting the economy slump would be bad for the budget. If Congress wants to make sure that surpluses continue and the debt is paid off, it should rein in federal spending and cut tax rates to keep the economy moving forward. Tax rate reduction, at the margin, is the key to a successful tax cut. Taxes do not boost the economy by giving people money to spend. They work by increasing the reward, at the margin, for incremental effort, saving, and investment. They may do so by cutting explicit marginal tax rates on labor and capital income, or by amending the tax base to eliminate the mismeasurement and multiple taxation of income used for saving and investment.

President Bush has proposed marginal rate cuts and the elimination or reduction of certain tax rate spikes that are triggered by some peculiar provisions of the tax code. His bill is an excellent place to start. It is not too big; if anything, it is too small. It should be implemented more rapidly than originally proposed. It should not be constrained by a "trigger". It should not be watered down in favor of faster elimination of the public debt.

The President's bill should be followed by further tax changes that lead toward fundamental tax reform. The goal should be to eliminate the tax biases against saving and investment at the individual and business levels, and to eliminate the tax spikes and complexities created by peculiar rules regarding deductions and credits in the current code.

Chart 1   Weighted Marginal Individual Income



Data Sources: Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, various issues; Inte Service, Statistics of Income Bulletin, various issues. (1978 omitted because IRS did not publish marginal rate dat The last bar shows what the weighted marginal tax rate would have been in 1997 if the rate brackets proposed by had been in effect then.

Chart 2 Individual Income Tax's Marginal Rates: Current L
Versus President Bush's Proposed Rate Brackets

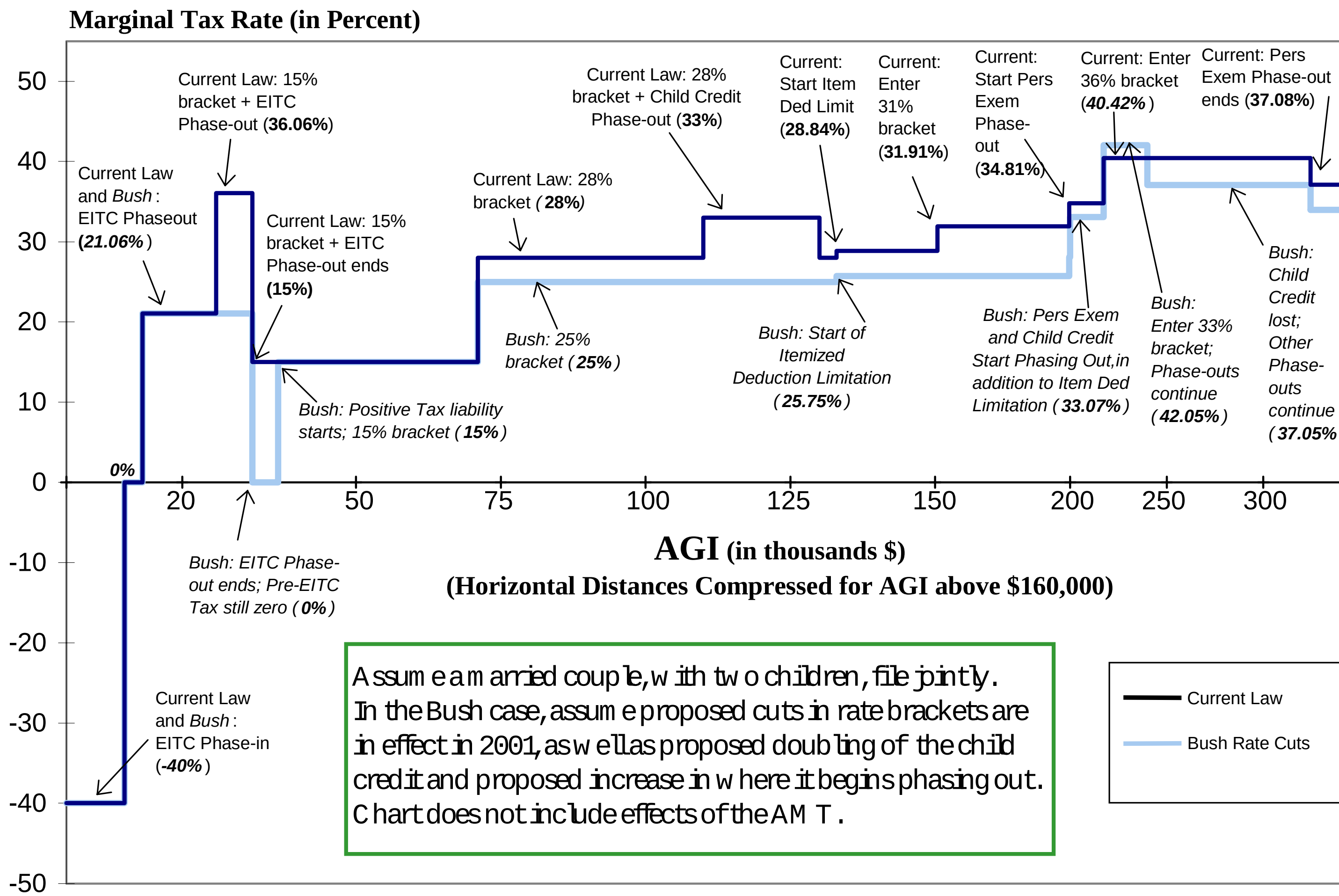
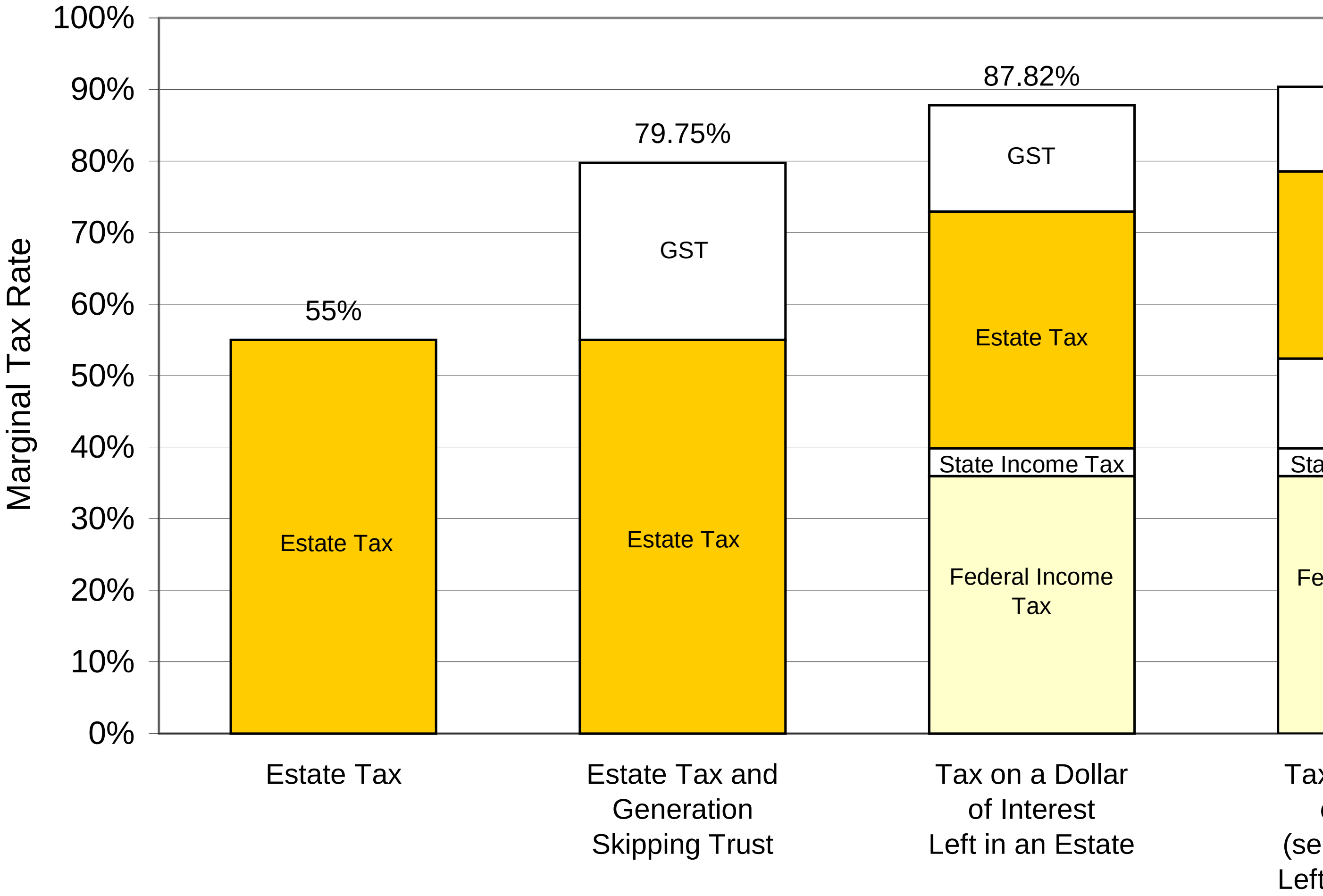


Chart 3 Marginal Tax Rates On Estates And Income Contributed To Estates



Assumes married couple in 36% tax bracket, who are self-employed, with a 6% state income tax as an itemized

Chart 4 Individual Income Tax's Marginal Rates: Current I
Versus President Bush's Proposed Rate Brackets

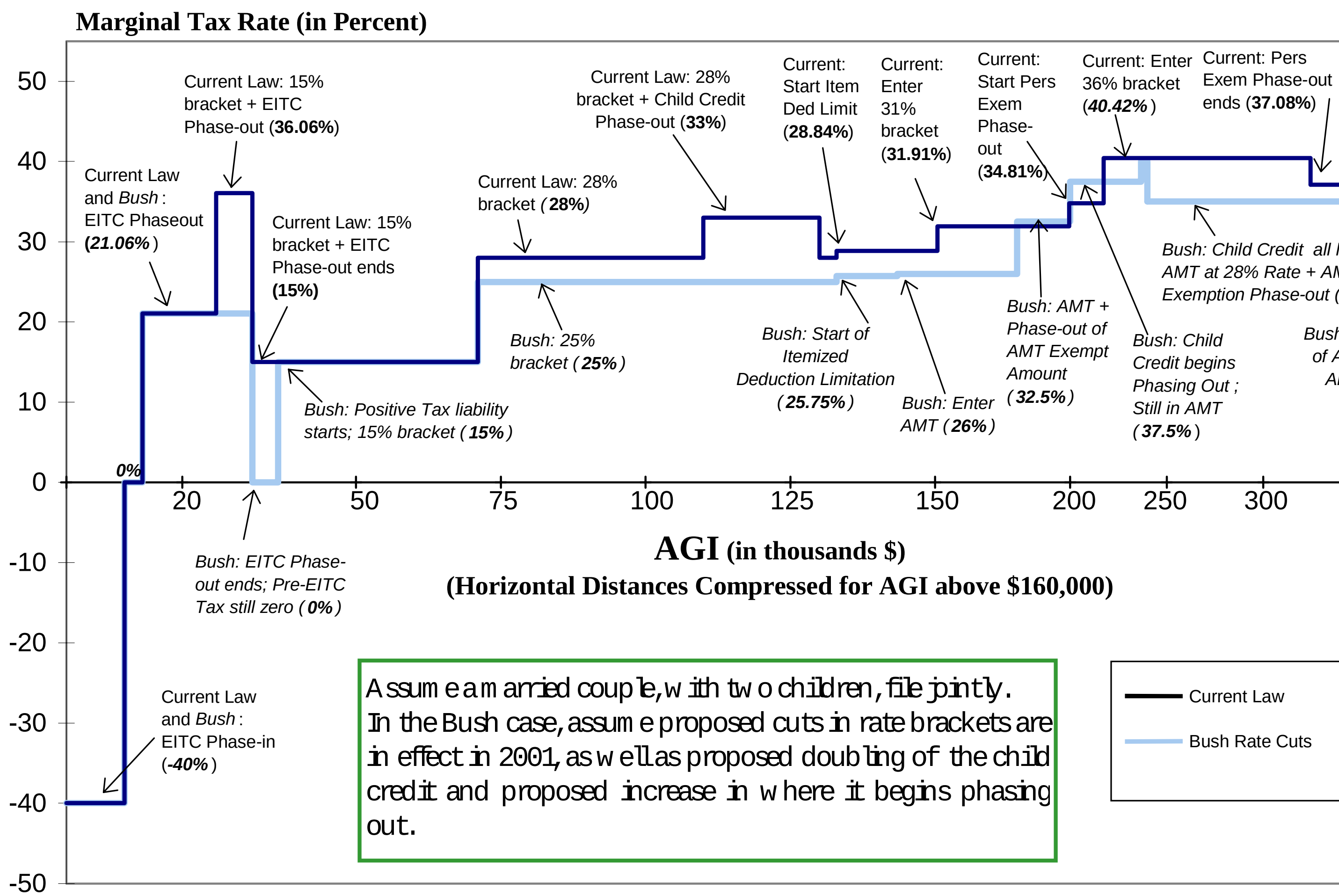


Chart 5 The AMT for Individuals Has Two Hidden Rat
Brackets Due to the Phase-Out of the AMT Exempt Amo
Married Couples Filing Jointly